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CIA/OER/IM 71-14 HIGHER WORLD PRICES FOR OIL
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DIRECTORATE OF
INTELLIGENCE

Intelligence Memorandum

The Short-Run Impact Of Higher World Prices For Crude Oil

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CENTRAL INTELLIGENCE AGENCY
Directorate of Intelligence
January 1971

INTELLIGENCE MEMORANDUM

The Short-Run Impact Of Higher
World Prices For Crude Oil

Introduction

The Organization of Petroleum Exporting Countries (OPEC)* is bargaining hard to gain a greater share of oil revenues. Last December, for one of the few times in OPEC's 10-year existence, both radical and moderate members united to present joint demands to the foreign oil companies. If granted, the higher taxes could hike oil revenues to the producer countries between \$2 billion and \$5 billion, or 25¢ to 60¢ per barrel in 1971 alone. Additional Libyan demands made outside the framework of the OPEC resolutions could raise the bill further. These demands follow the sizable tax increases already gained by Libya and the Persian Gulf governments last fall and by Venezuela as recently as December. This memorandum measures the magnitude of OPEC's recent gains and new demands for higher revenues and evaluates the short-term impact on Western Europe and Japan -- the major crude oil importing nations. For a brief discussion of the events leading up to the present crisis, see the Appendix.

* The ten members of OPEC are Iran, Iraq, Kuwait, Saudi Arabia, Abu Dhabi, Qatar, Libya, Algeria, Indonesia, and Venezuela.

Note: This memorandum was prepared by the Office of Economic Research and coordinated within the Directorate of Intelligence.

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West European and Japanese Dependence on Oil

1. Oil now provides most of the energy resources of Western Europe and Japan, and in the short run no other energy source could replace it. Oil provides two-thirds of the primary energy consumption in Japan and nearly 60% in Western Europe (see Table 1). Only a very few oil-burning facilities can quickly be converted to coal or natural gas. A major shift would take at least several years.

Table 1

Japan, OECD Europe:
Primary Energy Consumption
1969

	<u>Japan</u>		<u>OECD Europe</u>	
	<u>Million Tons of Oil Equivalent</u>	<u>Percent of Total</u>	<u>Million Tons of Oil Equivalent</u>	<u>Percent of Total</u>
Crude oil	162.3	67.4	560.3	58.8
Solid fuels	55.4	23.0	312.5	32.7
Hydro/nuclear	20.1	8.3	33.7	3.5
Natural gas	3.1	1.3	47.7	5.0
<i>Total</i>	<i>240.9</i>	<i>100.0</i>	<i>954.2</i>	<i>100.0</i>

2. As Western Europe and Japan have virtually no domestic oil supplies, uninterrupted access to foreign sources is vital to these countries. Japan buys almost all of its oil from OPEC while the proportion for Western Europe is 90%. Half of Western Europe's oil comes from the Persian Gulf; another 30% from North Africa; and the rest from West Africa, the USSR, the North Sea, and the Caribbean. Japan gets about 90% of its oil from the Persian Gulf -- roughly half from Iran and half from Arab states -- and the rest mostly from Indonesia.

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3. Because of rapidly growing demand, the dependence on OPEC countries will continue for the foreseeable future in spite of the development of new sources. Oil consumption in Western Europe and Japan has been growing at spectacular rates. In Western Europe its growth averaged about 11% annually during the last five years, while in Japan it averaged 18%. However, the growth in demand for oil is not expected to continue at these high rates. The rate of expansion of oil consumption already has begun to decline in Western Europe as the rate of conversion from coal to oil is slowing and natural gas is somewhat increasing its share of total energy consumption. Nevertheless, West European demand for oil is expected to grow at 8% annually through 1975. In Japan, demand through 1975 should rise by about 14% annually.*

4. Major sources of oil outside of OPEC are not likely to be developed in the next few years. Even though oil has been discovered in commercial quantities in the North Sea and on the Alaska North Slope, these sources could not be exploited sufficiently to supply more than a very minor share of the European and Japanese markets during the next few years. The North Slope, in particular, is not expected to provide any significant quantities of oil in the next few years, and most of it will be used in the United States. The East China Sea, where oil may also be found in commercial quantities, could not become a major supplier until at least 1975.

5. The West European countries, aware of their vulnerability to disruption of supplies, have been concerned with maintaining adequate reserve stocks of oil. Although statistics on stocks are incomplete and subject to rapid fluctuation, stockpiles in Western Europe in mid-January reportedly were at 60 to 80 days of consumption. Oil stockpiles in Japan averaged about 45 days in mid-1970.

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The Impact of Higher Oil Prices

6. The extent of the increase in crude oil prices that will result from the current negotiations between the oil producers and the oil companies is uncertain. The demands for revenue increases are ill-defined and in many cases conflicting. It is also unclear which consuming countries will be most adversely affected and which producing countries will most benefit because it is not known whether the settlement will include an across-the-board tax increase, a more complex reshuffling of the tax structure, or both of these. What is clear at this time, however, is that substantially higher revenue per barrel will be obtained by producers and that the oil companies will pass along most of their increased costs to the oil-consuming nations. Company receipts per barrel of oil have fallen markedly during the past few years as the share going to the oil-producing governments increased. The profits of the major international oil companies, while still considerable, now are only a small share of the price of delivered crude oil, and in the aggregate company earnings have not grown in the past three years in spite of rising output.

7. Currently, the most rumored settlement figure is about 30¢ per barrel, in addition to the 10¢ per barrel received in late 1970. On the basis of data presented in Table 2, which shows the impact of each increase of 10¢ per barrel on the imports of the major consumers, an increase of 40¢ per barrel would hike oil import costs by 18% in Western Europe and by 22% in Japan. The percentage increase is higher for Japan because delivered prices of crude oil are lower there. When the price increases are translated into import costs, Western Europe and Japan together would have to pay some \$2 billion more in 1971. Although these additional import costs seem high, they are small in comparison to these countries' total imports of more than \$150 billion in 1970. The higher prices would add only 1.1% to Western Europe's import bill and 2.9% to Japan's. The higher share for Japan reflects both the larger relative increase in oil prices and the larger share of oil in total imports compared with those for Western Europe. The impact on imports of

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Table 2

Impact on Western Europe and Japan of a 10¢ per Barrel Increase in Crude Oil Prices a/

	<u>Japan</u>	<u>West Germany</u>	<u>Belgium- Luxembourg</u>	<u>France</u>	<u>Italy</u>	<u>Netherlands</u>	<u>United Kingdom</u>	<u>Spain</u>	<u>Austria</u>
Average delivered price for crude oil (dollars per barrel)	1.81	2.20	2.31	2.27	2.10	2.20	2.32	2.19	2.33
Total crude oil imports (c.i.f.) (million US dollars)	1,906	1,449	482	1,436	1,555	781	1,610	448	39
Total imports of all commod- ities (c.i.f.) (million US dollars)	15,026	24,953	9,964	17,373	12,450	10,989	19,956	4,233	2,825
Crude oil imports as a per- cent of total imports	12.7%	5.8%	4.8%	8.3%	12.5%	7.1%	8.1%	10.6%	1.4%
Percent increase in delivered crude oil price if prices rise by 10¢ per barrel	5.5%	4.5%	4.3%	4.4%	4.8%	4.5%	4.3%	4.6%	4.3%
Value increase in imports if crude oil prices rise by 10¢ per barrel (million US dollars)	105	65	21	63	75	35	69	21	2
Percent increase in total imports if crude oil prices rise by 10¢ per barrel	0.7%	0.3%	0.2%	0.4%	0.6%	0.3%	0.3%	0.5%	0.1%

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Table 2

Impact on Western Europe and Japan of a 10¢ per Barrel Increase in Crude Oil Prices a/
(Continued)

	<u>Switzerland</u>	<u>Portugal</u>	<u>Ireland</u>	<u>Greece</u>	<u>Turkey</u>	<u>Sweden</u>	<u>Denmark</u>	<u>Finland</u>	<u>Total of Selected Countries</u>
Average delivered price for crude oil (dollars per barrel)	2.40	3.18	2.57	2.24	1.96	2.22	2.23	2.08	2.13
Total crude oil imports (c.i.f.) (million US dollars)	87	52	45	76	36	171	150	107	10,431
Total imports of all commod- ities (c.i.f.) (million US dollars)	5,285	1,232	1,411	1,594	747	5,876	3,812	2,023	139,749
Crude oil imports as a per- cent of total imports	1.6%	4.2%	3.2%	4.8%	4.8%	2.9%	3.9%	5.3%	7.5%
Percent increase in delivered crude oil price if prices rise by 10¢ per barrel	4.2%	3.1%	3.9%	4.5%	5.1%	4.5%	4.5%	4.8%	4.7%
Value increase in imports if crude oil prices rise by 10¢ per barrel (million US dollars)	4	2	2	3	2	8	7	5	490
Percent increase in total imports if crude oil prices rise by 10¢ per barrel	0.1%	0.1%	0.1%	0.2%	0.2%	0.1%	0.2%	0.2%	0.35%

*a. Based on 1969 data.*SECRET
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individual European countries would range from 0.3% in Switzerland to 2.4% in Italy. Most of the countries probably can cover these increased costs easily. A few countries with basically weak balance-of-payments positions, however, such as the United Kingdom, will face increased difficulties. In the unlikely event that all the oil-producing countries' demands are met and the price rises to 70¢ per barrel (including the 10¢ per barrel already received) the effect would be a 4.9% rise in the cost of total imports to Japan and 2.1% to Western Europe in 1971.

8. The price of crude oil in Western Europe and Japan would not come close to that in the United States even if the extreme price rise of 70¢ per barrel occurs. The average price per barrel of crude oil in the United States (\$3.50) in 1969 was \$1.28 more than in Western Europe and \$1.69 more than in Japan, reflecting the rationing of oil imports by the United States.

9. Higher import costs for crude oil would be passed on to final consumers of petroleum products if import tariffs and taxes on these products remain unchanged. These taxes are very substantial, adding much more than 100% to the total delivered cost of crude oil in all major countries of Western Europe and in Japan, as shown in Table 3.

10. These taxes represent a much larger share of the final value of petroleum products than do the tax receipts of the producing countries. Most of these taxes, however, are on gasoline, while those on fuel oil are small. This means that higher import costs would raise gasoline prices by only a very small percentage. Gasoline accounts for roughly 15% of petroleum consumption in Western Europe and 11% in Japan. The import cost of crude oil accounts for only about 8% of the total selling price of gasoline. The remainder is mostly taxes but also includes the cost of refining and marketing, as shown in Table 4. The rise of 40¢ per barrel would increase the pump price of gasoline only about 1¢ per gallon, or about 2% in Japan and 1½% in Western Europe.

11. In the case of heavy fuel oils, which account for 37% of petroleum usage in Western Europe and 57% in Japan, the percentage rise in

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Table 3
Excise Taxes and Customs Duties
Collected on Crude Oil and Petroleum Products

	Billion US \$		
	Excise Taxes and Customs Duties on Crude Oil and Petroleum Products	Crude Oil Imports	Excise Taxes and Duties Collected as a Percent of Crude Oil Imports
France	3.0	1.4	214
United Kingdom	3.1	1.5	207
West Germany	3.0	1.5	200
Italy	2.1	1.6	131
Japan	2.2	1.9	116

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Table 4

Cost Components
of Regular Gasoline
1970

	US Cents per US Gallon		
	<u>United States</u>	<u>OECD Europe</u>	<u>Japan</u>
Crude oil	8	5	4
Refining and marketing	17	17	16
Taxes	11	53	30
<i>Total</i>	<i>36</i>	<i>75</i>	<i>50</i>

prices will be greater because taxes account for only a small share of the selling price, which averages only about 7¢ a gallon. An increase of 40¢ per barrel of crude oil would increase heavy fuel oil prices about 1¢ per gallon, or about 15%. But while this seems high, the price impact on the final consumer is much less. Most heavy fuel oil is used to produce electricity, for space heating, and in various manufacturing processes. In the case of electricity generation, the price of electricity would rise some 1% in Western Europe and 2% in Japan if crude prices go up by 40¢ per barrel. Japan's higher increase reflects a greater use of fuel oil in thermal plants than in Western Europe. Small increases will also occur in most manufacturing uses. For example, the Japanese steel industry uses about 10% of all heavy fuel oil and would have to raise its steel prices an infinitesimal 9¢ a ton in order to compensate for higher fuel oil prices. Industries where petroleum product outlays are a very high share of total cost, such as petrochemicals, will be more affected. They account for only a small share of all users.

12. The impact of an increase in the crude oil price in the United States would be considerably less than for Western Europe. The United States produced 78% of the oil it used last year. Another 5% came from Canada, which is a high-cost crude

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producer and solely dependent on the US market for its foreign crude sales. Thus with only 17% of US consumption coming from other countries (mainly Venezuela), the impact of an increase of 40¢ per barrel on the US import bill would be \$360 million, or less than a 1% increase in total imports. The net impact on the US balance of payments might even be positive as the gap would narrow between what the US refiners pay for crude oil and what is paid by refiners in Western Europe and Japan. The US petrochemical industry, for example, would then be better able to compete at home and abroad.

13. While the costs to the consuming countries would not be great, the gains to the producing countries would be very large indeed. A rise of 40¢ per barrel in crude oil revenues would by itself increase government revenues in these countries by about 30% and their exports by 20% in 1971* (see Table 5). These gains will come not only from Western Europe and Japan, but also from other purchasers, which buy 37% of OPEC exports. For those countries with a relatively small population, especially Libya, Kuwait, and the Persian Gulf sheikdoms, the increases would be far more than they could currently spend and most would probably end up in foreign exchange reserves. Thus part of these added earnings would end up back in the consuming countries as dollars, sterling, and continental European currency deposits. The more populous countries of Iran and Indonesia, whose import needs are much larger and whose foreign exchange positions are much weaker than those of the smaller OPEC countries, would be able to liberalize their exchange controls to expand imports and to allow an increased outflow of profit earnings and capital.

* If the USSR also hikes its oil prices by 40¢ per barrel, it would increase its hard currency earnings by about \$80 million in 1971, about 4% of total hard currency earnings of \$2.1 billion in 1969. Soviet hard currency earnings from crude oil exports, largely to Western Europe, amounted to \$340 million in 1969.

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Table 5
Impact on OPEC of a 10¢ per Barrel Increase in Crude Oil Prices ^{a/}

	<u>Iran</u>	<u>Iraq</u>	<u>Kuwait</u>	<u>Saudi Arabia</u>	<u>Abu Dhabi</u>	<u>Qatar</u>	<u>Libya</u>	<u>Algeria</u>	<u>Venezuela</u>	<u>Indonesia</u>	<u>Total</u>
Average f.o.b. price for crude oil (dollars per barrel)	1.60	1.84	1.44	1.77	1.35	1.52	1.90	2.00	2.15	1.90	1.82
Total crude oil exports (million US dollars)	1,854	973	1,449	2,050	294	198	2,151	616	2,677	372	12,634
Total exports of all commodities (million US dollars)	2,099	1,042	1,476	2,051	294	198	2,165	934	2,892	831	13,988
Value increase in exports if crude oil prices rise 10¢ per barrel (million US dollars)	116	53	101	116	22	13	113	31	125	20	710
Percent increase in total exports if crude oil prices rise by 10¢ per barrel	6%	5%	7%	6%	7%	7%	5%	3%	4%	2%	5%
Total government revenue (million US dollars)	1,930	790	740	1,160	200	110	1,490	1,190	1,980	N.A.	9,590
Total government oil revenues (million US dollars)	938	484	676	1,009	192	96	1,132	274	1,290	N.A.	6,091
Value increase in government revenues if crude oil revenues rise 10¢ per barrel (million US dollars)	116	53	101	116	22	13	113	31	125	20	710
Percentage increase in total government revenues if crude oil revenues rise 10¢ per barrel	6%	7%	14%	10%	11%	12%	8%	3%	6%	N.A.	7%

a. Based on 1969 data.

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Conclusions

14. Current negotiations between representatives of OPEC and the oil companies are likely to result in sizable revenue increases for the oil-producing countries. OPEC demands imply an increase in the cost of crude of between 25¢ and 60¢ per barrel. The oil companies indicate that the most likely increase will be about 30¢ per barrel. This gain would be in addition to a revenue hike already won in late 1970 by many OPEC countries which increased oil-producing countries' revenues by 10¢ per barrel. A rise of 40¢ per barrel in revenues in 1971, even without considering a rising volume of sales, would boost OPEC government revenues by 30% and exports by 20%.

15. Unless the currently discussed bargaining range is increased sharply, however, the major consuming countries of Western Europe and Japan almost certainly will be able to absorb the costs without economic disruption. A price increase of 40¢ per barrel would raise the cost of oil imports to these countries by \$2 billion, only slightly more than 1% of total imports of over \$150 billion in 1970. Moreover, most of the additional revenues of the oil-producing countries would flow back to the developed countries as payments for more imports and as deposits of additional foreign exchange reserves. Consumer prices for petroleum products in Western Europe and Japan would rise by only about 1% in 1971 because of the higher crude prices, far less than current inflationary increases for all goods. Japan would be somewhat more adversely affected than Western Europe, mainly because a higher share of Japan's energy consumption is supplied by oil.

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APPENDIX

Background

OPEC was formed 10 years ago mainly to acquire higher oil revenues per barrel from the oil companies by a combination of higher prices and a larger share of the profits. But only minor increases in revenues were obtained and these from individual and not OPEC-wide negotiations. Despite their control of more than 85% of Free World oil exports, OPEC failed mainly because member countries could not get together on rationing output. Each producing country, while anxious to increase its income per barrel, was even more interested in increasing its total income. The quickest and surest way of doing this was to increase production, not decrease it. Thus, individual countries were at times willing -- in fact, anxious -- to take advantage of one another's difficulties in order to gain more total revenue by expanding output.

In the decade preceding the 1967 war, a rapid expansion of oil output and development of new oil sources, such as in Libya, which were not controlled by the established major oil companies, brought a steady slide in oil prices. The drop in prices mainly came out of company profits per barrel of oil, although total company profits tended to rise. The tax receipts of OPEC member governments grew rapidly in the aggregate and were about stable per barrel of oil. On the other hand, the price level for goods imported by oil-producing countries went up so that the real purchasing power of their revenue rose less than the dollar value.

Closure of the Suez Canal in June 1967 changed the world oil market. Through quick action by governments and companies, tankers were re-routed around the tip of South Africa. Overnight a substantial tanker surplus became a tanker shortage. Fortunately, production in short-haul areas -- particularly Libya -- increased rapidly and so did construction of supertankers which could carry oil

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cheaply around Africa and, in any case, were too big to go through the canal. Although European consumers were somewhat apprehensive of this growing dependence on Libya (see the table), especially after the radical-led coup in September 1969, crude imports from Libya continued to grow. By mid-1970 Libya was supplying about 25% of Western Europe's crude oil.

A new world petroleum crisis was precipitated in mid-1970. A major supply line between Saudi Arabian oilfields on the Persian Gulf and the Mediterranean, the Trans-Arabian Pipeline (TAPLINE), was shut down in May 1970 after what appears to have been an accidental rupture of the line in Syria. The Syrian Government did not agree to the proffered terms for its repair and reopening, and the supply from this source, formerly providing 4% of West European needs, had to be moved by the long tanker route from the Persian Gulf. Shortly thereafter the Libyan regime imposed successive production cutbacks on several oil companies, eventually reducing output by 750,000 barrels per day (equivalent to some 5% of Western Europe's oil consumption). These cutbacks further strained the world's tanker fleet and caused tanker rates, then on a downward course, to rise to unprecedented levels. Subsequently, oil supplies in Western Europe tightened markedly and prices there rose steeply, largely to offset higher transport costs.

Tripoli was in an ideal position to press new demands on the oil companies. Tanker capacity was insufficient to allow for rapid major shifts in production to distant areas such as the Persian Gulf, and Libya's currency reserves were so high -- about \$1.7 billion -- it could have afforded a complete stop in production for some time. Seizing its advantage, Libya became the first oil-producing country to impose non-negotiable demands for higher posted prices* and tax rates. Tripoli argued that

** Posted prices are those set by the oil-producing countries and the oil companies to determine the profit split. They may be above or below the actual selling price. In the 1960s they were consistently well above actual prices.*

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Libya: Exports of Crude Oil
to Selected West European Countries
1969

	<u>Belgium/ Luxembourg</u>	<u>Netherlands</u>	<u>West Germany</u>	<u>France</u>	<u>Italy</u>	<u>United Kingdom</u>
Million barrels	44	76	297	107	211	157
Percent of total oil imports	21	21	45	17	28	23
Value in million US \$, c.i.f.	100	168	651	228	432	363

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the companies raised the price of Libyan crude oil after the Suez closure to reflect the higher delivered prices for Persian Gulf crudes in Europe but that the government had not shared in these increased profits. From this windfall Libya got revenue increases from the oil companies amounting to about 30¢ per barrel by September 1970. Following Tripoli's successful negotiations with the companies, Persian Gulf governments quickly demanded higher oil revenues for themselves, arguing that Libya had been over-compensated for its transportation advantage. The producing country was granted increased posted prices and the tax cut was raised from 50% to 55% of calculated profits. As a result, Persian Gulf producers gained additional revenue amounting to about 15¢ per barrel.

Next in this round of tax increases, Venezuela went well beyond the Persian Gulf producers. It not only obtained additional revenues, but also set up an unprecedented method for determining the effective tax rate on crude oil production. The Venezuelan Congress had been faced with a budget deficit and, rather than levy an unpopular sales tax, it turned to higher oil revenues for relief. New legislation passed in December 1970 raised the income tax on oil profits from 52% to 60% and made it retroactive to January 1970. Moreover, the law gives the government the unilateral right of setting the tax reference price. An OPEC official noted this "historical precedent" and commented that it would result in producing governments setting their own taxes. Together the three tax increases -- from Libya, the Persian Gulf states, and Venezuela -- will boost host governments' revenues by about \$700 million, and as a result world import prices for crude oil will likely rise by more than 10¢ per barrel.

OPEC met in Caracas in December 1970, at the same time that the new Venezuelan oil legislation passed, and adopted resolutions aiming at further substantial increases in oil revenues. The resolutions called for an undisclosed across-the-board increase in posted prices, a minimum tax rate of 55% on oil company income, uniform pricing

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arrangements for each grade of oil based on the highest price existing within OPEC, and premium prices to those countries whose oil would otherwise be cheaper in the consumers' markets because of shorter transport distances. Several other price adjustments, possibly including adjustments for any future exchange rate changes and price inflation, would provide additional revenue. OPEC may also plan to demand compensation for the depreciation of the dollar (because of rising prices) during the past 12 years. The only other major suppliers to Western Europe and Japan are Nigeria and the USSR, and they would likely raise their prices along with OPEC.* Industry observers believe that OPEC demands could increase tax revenues by between \$2 billion and \$5 billion for 1971, depending on the terms of the final settlement. In terms of revenue per barrel, this would mean an increase of between 25¢ and 60¢ per barrel.

However, OPEC is still far from united on the issues. A tripartite committee consisting of Iran, Iraq, and Saudi Arabia as representatives of the Persian Gulf producers presently is presenting demands to the oil companies. The main Mediterranean producers, Libya and Algeria, in what appears to be closely coordinated tactics, have been exerting great pressure during their respective encounters with the oil companies and the French Government. The French/Algerian oil relationship under which Algeria receives premium prices for its oil in the French market is closely bound up in the complex of Franco-Algerian relations and is under review by the two governments. Libya's demands, which already exceed those made by OPEC, include such demands as obligatory re-investment of oil company profits, supply of crude oil and gas at cost for local requirements, and additional compensation to reflect Libya's short-haul freight advantage.

* Most of Nigerian oil is sold under contracts which have clauses automatically increasing tax rates to match those granted in Libya and Algeria.